

**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

**Investigation by the Department of Telecommunications and Energy)
on its own Motion into the Appropriate Regulatory Plan to succeed)
Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon)
Massachusetts' intrastate retail telecommunications services in the)
Commonwealth of Massachusetts)**

**D.T.E. 01-31
Phase II
Track B**

INITIAL BRIEF OF THE ATTORNEY GENERAL

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I. INTRODUCTION AND SUMMARY OF ARGUMENT

The Attorney General for the Commonwealth of Massachusetts ("Attorney General") files this Initial Brief pursuant to the Hearing Officers' August 22, 2002, procedural memorandum. The Department of Telecommunications and Energy ("Department") ordered that, in this phase of the case ("Phase II, Track B"), parties address a plan, proposed by Verizon New England, Inc., d/b/a Verizon Massachusetts ("Verizon" or "Company"), for regulating retail residential rates.¹ Verizon has asked the Department to raise residential dial tone rates initially by more than \$2.00 per telephone line per month (up to approximately twenty-five percent).²

¹ Verizon's proposals are not inconsistent with directives contained in the Department's Order in the first phase of this docket. *Verizon*, D.T.E. 01-31 (Phase I) Order, p. 105 (May 8, 2002) ("Phase I Order").

² The Department "tentatively concluded" that: "switched access rates should be reduced to interstate levels, and special access rates should be reduced to unbundled network element ("UNE") based levels, with the revenue shortfall recovered from fixed charges for residential dial tone lines." Phase I Order, p. 101. The Department instructed Verizon to "include such provisions within its proposal submitted in Phase II of this proceeding." *Id.* Verizon, in response, proposes to raise all Massachusetts residential dial tone charges from the current \$9.91 to up to \$12.35. Exh. VZ-2, p. 14. Verizon would raise residential rates, purportedly on a "revenue neutral" basis, to recover revenues (estimated \$61 million annually) that the Company allegedly will lose from reductions in access fees it previously

(continued...)

The Department asked about other possible changes in this case that would raise the residential dial tone rates initially by approximately \$7.00 per telephone line per month (over seventy percent). The Department should reject the proposed dial tone rate increases because no party has shown either that Verizon is legally entitled to such increases or that the increases actually would be revenue neutral to the consumer.

Verizon also proposes to change dramatically the way the Department establishes rates for basic residential telephone service. For decades, the Department set rates based on costs.³ Verizon now asks the Department for authority to raise basic residential rates up to five percent each year, indefinitely, without reference to current or recent costs, and without further Department review.⁴ The Department should reject the methods of setting residential rates proposed by Verizon and AT&T because these methods are inconsistent with the Department's

²(...continued)
recovered from interexchange carriers like AT&T Communications of New England, Inc. ("AT&T"), WorldCom, and Sprint. Exh. VZ-2, Attachment A, Tab B, Attachment II, page 5. Also, Verizon would include Touch-Tone service (formerly optional) and certain payphone and collocation charges in the dial tone rate. Exh. VZ-2, p. 14.

³ Since 1995, the Department has set most of Verizon's rates under a "price cap" method of regulation, with a "price freeze" preventing increases for basic residential service. Under the price cap regime, the Department has allowed Verizon to change individual rates, provided that its revenues may not exceed the overall revenue requirement set by the Department, as adjusted annually for inflation and productivity. *New England Telephone and Telegraph Company*, D.P.U. 94-50 (1995). While the Department has found that it no longer needs to set business service rates because those markets are "sufficiently competitive," the Department did not make a similar finding for residential markets. Phase I Order, p. 91.

⁴ Verizon refers to cost data from 1993 and earlier. Exh. AG-1, p. 1, 4; *New England Telephone and Telegraph Company*, D.P.U. 94-50 (1995). Given the many changes in telecommunications markets since 1993, those data are too stale to be used as a basis for setting rates prospectively, much less going forward for an indefinite period.

statutory mandate. G.L. c. 159, § 20.⁵ The Department must set rates that are “just and reasonable,” providing a return to Verizon that is neither so low as to be confiscatory, nor so high as to be exorbitant. G.L. c 159, §20; *An Appeal of Public Service Company of New Hampshire*, 547 A.2d 269, 271; 96 PUR 4th 536 (1988) (“a utility’s charges are appropriate if they fall within a zone of reasonableness between the extremes of confiscating the utility’s property, at one end, and exploiting customers for the utility’s benefit at the other.”) (Souter, J.). Massachusetts law does not authorize the Department either to delegate its rate setting responsibility to Verizon or to ignore Verizon’s level of earnings. Furthermore, ever-increasing basic telephone service rates may force some customers to drop their telephone service, or prevent others from obtaining service, contrary to the Department’s goal of universal service. Based on the record, the Department should not raise basic residential rates. Instead, the Department should freeze residential rates at their August 15, 2001 levels until it finds, after a full review of Verizon’s current earnings, an independent audit of Verizon’s regulatory accounting and current cost of service studies, that Verizon’s costs to serve residential customers exceed that class’s revenues. The Department also should strengthen Verizon’s current service quality plan.

II. STATEMENT OF THE CASE

In its Order opening its investigation into Verizon’s alternative regulation plan, the Department said that it would “review the appropriate policy to succeed price cap regulation for Verizon's retail intrastate telecommunications services in Massachusetts.” DTE 01-31 (Phase I) Vote and Order to Open Investigation, p. 1 (February 27, 2001). The Price Cap Plan expired

⁵ Verizon seeks authority to raise residential rates up to five percent per year without Departmental review, while AT&T requests that the Department allow Verizon to raise rates up to ten percent per year without review for the next three years. Exh. ATT-1, p. 16.

August 15, 2001. In response to the Department's order, Verizon filed a regulatory plan on April 12, 2001 ("Phase I Plan"), that capped the basic residential rates (dial tone and usage) for three years, allowed other residential services to change only on an allegedly revenue-neutral basis, allowed business services and all other intrastate service rates to fluctuate according to market demands, and provided for the possibility of a reduction in intrastate switched access rates. Verizon proposed to continue the service quality plan established in D.P.U. 94-50 with a modification to the penalty payment methodology. Exh. VZ-4.

On June 21, 2001, the Department bifurcated the investigation and halted any further consideration of Verizon's Phase I Plan.⁶ D.T.E. 01-31 (Phase I), Interlocutory Scoping Order, p. 17. The Department stated that in Phase I it would examine whether there was sufficient competition to deregulate any of Verizon's regulated residential or business services. The Department designed Phase II of the investigation to consider which alternative regulation plan – including traditional cost-of-service, indexed price cap regulation, and any intervenor-proposed plans – might be most appropriate for retail services that are not sufficiently competitive to merit removal of pricing constraints. *Id.*, pp. 17-19.

⁶ "Accordingly, we bifurcate this proceeding into consecutive phases. In the first phase of this proceeding, we will undertake an investigation into the levels of competition, the specific standard of review, and the necessary Department findings regarding sufficient competition. The content of the second phase of this proceeding will be governed by the outcome of the first. If Verizon meets its burden of proof to show that the services for which it seeks pricing flexibility are sufficiently competitive and that competition is sufficient to warrant the use of an alternative form of regulation for other services, the second phase will consist of an investigation into whether Verizon's proposed plan, or later-filed intervenors' plans, for regulatory treatment of those services is appropriate. If Verizon has not met its burden in the first phase, the second phase will consist of an investigation into which form of regulation, be it a continuation of price cap, a restoration of rate-of-return regulation, or some alternative, is appropriate for the level of competition demonstrated by our investigation in Phase I." D.T.E. 01-31 (Phase I), Interlocutory Order on Scope, pp. 17-18 (June 21, 2001).

On May 8, 2002, the Department determined that there was sufficient competition for most of Verizon's retail business services to allow Verizon pricing flexibility for those business services. Phase I Order, pp. 91-92. Verizon did not seek pricing flexibility for residential services, but the Department stated in "tentative conclusions" that "it is not feasible or desirable to institute cost-of-service regulation for only one set of Verizon customers." *Id.*, p. 97. The Department tentatively concluded that "some form of alternative regulation (e.g., rate freeze, price cap, revenue cap, or some combination of these) may be appropriate for Verizon's residential services and would not be inconsistent with precedent." *Id.*, p. 98. The Department tentatively concluded that "historic evidence has shown that residential rates are likely below their efficient levels" (*id.*), and provided guidance, but not findings, regarding the Department's process for evaluating whether Verizon's Plan would produce just and reasonable residential retail rates. The Department stated that rates would be just and reasonable if they fell between a floor of incremental costs (with no recovery for joint and common costs) and a ceiling of stand-alone costs (incremental costs plus all joint and common costs). *Id.*, pp. 99-100; D.T.E. 01-31 (Phase I) Order on Reconsideration (August 5, 2002), p. 8. The Department also noted that "we can look to principles of competitive pricing for standards to judge whether regulated prices for specific services are just and reasonable. In competitive markets for telephone services, efficient market prices are based on incremental cost plus a mark-up for joint and common costs, based on Ramsey pricing principles." *Id.*, p. 99.

On June 5, 2002, Verizon, in response to the Department's Phase I Order, filed an Alternative Regulation Plan ("Phase II Plan") for residential customers that was markedly different from its original proposal. Instead of a rate freeze for basic residential services for three

years, Verizon now proposes to increase dial tone rates by about 25 percent and requests authority to raise residential rates up to five percent each year indefinitely without further Department review. The Attorney General and other parties filed comments on the Phase II Plan on June 25, 2002. On August 1, 2002, the Department proposed a procedural schedule dividing its retail rate investigation into two tracks and creating a third phase.⁷ The Department held four public hearings on the Phase II Plan.⁸ The Hearing Officer denied the Attorney General's August 22, 2002, request to expand the procedural schedule to allow sufficient time to conduct a review of Verizon's earnings, a cost of service study, and an independent audit of the Company's regulatory accounting before allowing Verizon to raise rates without Departmental review. Tr. 1 (August 22, 2002 procedural conference), pp. 6-12, 18-19, 23-24. The Attorney General appealed the Hearing Officer's decision, and the Commission denied the appeal. D.T.E. 01-31 (Phase II), Interlocutory Order on Appeal by the Attorney General of Hearing Officer's Ruling on the Procedural Schedule (September 3, 2002), p. 6.

The Intervenors in Phase I remained parties in the Phase II proceeding.⁹ The parties and

⁷ Track A will review Verizon's Phase I Order compliance filing for retail business services and Track B will review appropriate regulatory frameworks and service quality plans proposed by Verizon and others for retail residential services. Department August 1, 2002, Memorandum, p. 1.

⁸ The public hearings were held on August 27, 2002 (Pittsfield), August 29, 2002 (Worcester), September 3, 2002 (Boston), and September 5, 2002 (New Bedford). Pittsfield City Councilor Peter Arlos asserted in a written statement to the Department that Verizon did not give adequate public notice of the Pittsfield public hearing. Written comment by Peter G. Arlos, City of Pittsfield Councilor (August 28, 2002). Councilor Arlos appears to be correct. A comparison of the Department's August 6, 2002 Order of Notice and Verizon's September 11, 2002 submission of notices of publication reveals that Verizon failed to publish any of the notices for the four public hearings by the date set forth in the Department's Order of Notice. Furthermore, Verizon failed to publish the public notices at least 21 days before the Pittsfield and Worcester public hearings, as required by G.L. c. 159, § 20.

⁹ The Department granted full intervenor status to Allegiance Telecom of Massachusetts, Inc.,
(continued...)

the Department conducted discovery on Phase II of the investigation.¹⁰ Verizon filed direct testimony on August 28, 2002; the Attorney General and AT&T filed rebuttal testimony on September 4, 2002; and Verizon filed its rebuttal testimony on September 18, 2002.

The Department conducted evidentiary hearings at its Boston offices on October 22 through 24, 2002, during which Dr. David Gabel testified for the Attorney General; John Conroy, Dr. William E. Taylor, and Paula Brown testified for Verizon; and Dr. John Mayo testified for AT&T.

III. STANDARD OF REVIEW

A. Departmental Review of Proposed General Rate Increases

Massachusetts law requires that when a common carrier proposes rate changes that “represent a general increase in rates,” the Department must hold a public hearing and investigate the propriety of the proposed changes. G.L. c. 159, § 20.¹¹ The Department must publish notice

⁹(...continued)

AT&T, Global NAPs, Inc., Network Plus, Inc. (“Network Plus”), New England Cable Television Association, New England Public Communications Council, Inc., Sprint Communications Company, L.P., The Association of Communications Enterprises, Qwest Communications Corporation, XO Communications, Inc., and WorldCom, Inc., and limited participant status to Boston Gas Company d/b/a Keyspan Energy Delivery New England. Allegiance Telecom subsequently withdrew from the case. D.T.E. 01-31 (Phase I), Attorney General Initial Brief, p. 3; D.T.E. 01-31 (Phase II) Hearing Officer ruling, July 2, 2002.

¹⁰ The Hearing Officer ordered that in Track B, discovery, hearings, testimony, and briefing would be allowed on Track A issues (i.e., Verizon’s retail business services) only as they relate directly to Track B issues.

¹¹ “Whenever the department receives notice of any changes proposed to be made in any schedule filed under this chapter which represent a general increase in rates by a common carrier furnishing the service of transmission of intelligence by electricity, it shall notify the attorney general of the same forthwith, and shall thereafter hold a public hearing and make an investigation as to the propriety of such proposed changes after first causing notice of the time, place and the subject matter of such hearing to be published at least twenty-one days before such hearing in such local newspapers as the department
(continued...) ”

of the public hearing at least twenty-one days before the hearing.¹² *Id.* The Department is authorized to “determine the just and reasonable rates” where it concludes, after a public hearing and investigation, that rates are “unjust, unreasonable, unjustly discriminatory, unduly preferential, in any wise in violation of any provision of law, or insufficient to yield reasonable compensation for the service rendered.” G.L. c. 159, § 14.

Verizon must demonstrate that its proposed alternative rate plan would produce just and reasonable and non-discriminatory rates. G.L. c. 159, §§ 14 and 20. The common carrier also bears the burden of showing that its proposed increase “is necessary to obtain reasonable compensation for the service rendered” G.L. c. 159, § 20. “The burden of proving the propriety of a rate increase remains with the utility seeking the increase.” *Town of Hingham v. Department of Telecommunications and Energy*, 433 Mass. 198, 213-214 (2001); *Metropolitan District Commission v. Department of Public Utilities*, 352 Mass. 18 (1967). Rates must reflect only those costs the Department finds to be reasonably and prudently incurred for providing service to customers. *Western Massachusetts Electric Company*, D.P.U. 85-270, p. 20 (1986).

B. Service Quality Plans

As part of its public service obligation, Verizon must provide adequate service to its customers. The Company must design a service quality plan that ensures it does not have an

¹¹(...continued)

may select. ... At any such hearing involving any proposed increase in any rate, joint rate, fare, telephone rental, toll or charge, the burden of proof to show that such increase is necessary to obtain a reasonable compensation for the service rendered shall be upon the common carrier.” G.L. c. 159, § 20.

¹² All telecommunications carriers subject to the Department’s jurisdiction must provide at least thirty days’ advance written notice to customers of any proposed increase in business and residential retail rates. G.L. c. 159, § 19; Exh. AG-5. Verizon agreed to abide with this notice requirement. Tr. 1, pp. 68-69.

incentive to cut costs to the detriment of service quality. *New England Telephone and Telegraph Company*, D.P.U. 94-50, p. 236, n. 134 (1995). In evaluating whether a service quality plan is reasonable and adequate, the Department considers five factors: (1) the data to be included in the report; (2) the format of the information to ensure that the data are presented in a consistent and meaningful fashion; (3) the frequency with which the data are reported and filed with the Department; (4) the standards by which quality of service indicators are measured; and (5) the extent to which the company's review of the various quality of service indicators leads to corrective action. *New England Telephone and Telegraph Company*, D.P.U. 89-300, pp. 300-301 (1990).

IV. ARGUMENT

The Department should reject the proposals to increase residential dial tone rates between \$2 and \$7 per month to recover estimated revenues lost from reductions to rates for switched access and other services. The Department should also deny Verizon's request to raise residential retail rates up to five percent each year without Departmental review.

A. The Department Should Reject Verizon's Request To Raise Residential Dial Tone Rates.

The Department ordered Verizon to calculate the estimated revenue reduction that would occur if Verizon were to reduce its intrastate switched access charges to interstate levels.¹³ Phase I Order, p. 101. Verizon estimates that it will lose \$61 million annually from such reductions. The Company proposes to raise residential dial tone rates to recover that amount, to make Touch-Tone service mandatory, and to include the Touch-Tone charge in the dial tone rates. Exh. VZ-2,

¹³ Intrastate switched access charges are the rates interexchange carriers like AT&T, WorldCom, and Sprint pay to Verizon for carrying intrastate toll calls.

Attachment A, Tab B (revised 8/28/02), Attachment 1, Workpaper 1.¹⁴ Verizon calculates that monthly residential dial tone rates for its 2.75 million residential customers would have to rise between \$1.97 and \$2.44 to allow Verizon to recover the \$61 million annually. *Id.*¹⁵

The Department asked Verizon to calculate how much the residential dial tone should increase if the Department chose to reduce Verizon's Eastern LATA business and residential toll rates to Western LATA toll rates and lower intrastate business and residential special access rates to UNE rates. Exh. DTE-VZ 3-3; Exh. DTE-VZ 3-4 (proprietary). Verizon estimated that these changes would reduce the Company's revenues (above the \$61 million) by \$36 million (Eastern LATA) and as much as \$350 million (special access) annually, resulting in additional increases in monthly residential dial tone rate of \$1.17 (Eastern LATA) and over \$4.00 (special access). *Id.*; Tr. 2, pp. 110-112; Exh. DTE-VZ 3-4; Exh. DTE-VZ 3-5. Even though much of the allegedly lost revenue would come from business services, Verizon contends that the residential dial tone, rather than any other business or residential service, should be increased to recover the anticipated lost revenues because: "it is our belief that residence dial-tone line remains the most inelastic service, and that's where we would have to make the increase." Tr. 2, p. 116 (Ms. Brown).

If the Department adopts all of the proposals – reduce intrastate switched access charges,

¹⁴ Currently, Touch-Tone service is an optional feature.

¹⁵ Ms. Brown testified that: "The company's proposal is a total per customer that does not have Touch-Tone now, could ultimately see an increase of \$2.44. That would include the dial-tone offset for the switched access, collocation, PAL and PASL rates, and the Lifeline adjustments; all of the adjustments that we've detailed in our workpapers would total \$2.44 for customers without Touch-Tone. It would be \$1.97 for customers who currently have Touch-Tone, would be their increase." Tr. 2, pp. 109-110.

revise PAL/PASL and collocation charges, lower Eastern LATA toll, and lower intrastate special access rates – and makes up those estimated lost revenues by raising residential dial tone, Verizon intends to raise basic residential service by over \$7 per month. The Department did not, however, direct Verizon to produce cost studies or submit to an earnings review that would support its estimates for current earnings, anticipated revenue losses, and service costs.

1. Raising residential dial tone alone to meet Departmental directives is unfair, discriminatory and otherwise inappropriate.

Verizon contends that it should be allowed to recover the \$61 million to \$386 million anticipated losses through increased residential dial tone charges, allegedly on a “revenue-neutral” basis. Exh. VZ-2. Verizon argues that increasing residential dial tone charges is appropriate because that is the most inelastic rate element and there are few alternatives to dial tone service, Tr. 2, p. 116-117, and states that it currently controls over 85% of the intraLATA residential market statewide. Exh. AG-VZ 5-8.

The Department should reject Verizon’s proposed residential dial tone increases for several reasons. First, Verizon bases its proposal to increase dial tone rates on estimates, not actual numbers of lost revenues. Exh. VZ-2, Attachment A, Tab B, Attachment I, Workpaper 1 (revised 8/28/02). The Company has not provided evidence that its predictions are at all accurate, and Verizon may reap a windfall if its actual losses are not as much as its estimated losses. A better, fairer approach would be to recover only actual lost revenues and conduct an earnings review to ensure that the increases are necessary for Verizon to obtain reasonable compensation. Second, there is no record evidence showing that interexchange carriers will pass along their savings from reduced intrastate access charges to Verizon’s customers, so increases in

dial tone may not be revenue neutral to the consumer. Exh. AG-VZ 3-20, quoting Dr. Taylor's response to Exh. DTE-VZ 1-10 (Phase I).

Third, any revenues lost from switched access rate reductions, PAL and PASL rate changes, collocation rate changes, and special access rate changes would come from both business and residential customers. Verizon's proposal is unfair, unjust and discriminatory because only residential customers are being asked to shoulder the burden of compensating for Verizon's lost revenues. The Department found long ago that residential ratepayers should not be treated as the guarantors of the Company's recovery of its revenue requirement. *IntraLATA Competition*, D.P.U. 1731, pp. 28, 31-36 (1985). Fourth, the concept of revenue neutral adjustments to residential dial tone is a method used under rate-of-return regulation, which the Department has already found to be inappropriate. Phase I Order, p. 97.¹⁶

Fifth, recovery of shared costs from end-user dial tone would be economically inefficient. The loops used to supply access are becoming more traffic sensitive and shared among multiple end-users and digital subscriber line ("DSL") users as they are upgraded from all copper to fiber optics and digital electronics. The Department has determined that such equipment is engineered based upon busy hour usage, which is traffic sensitive. Tr. 2, p. 223. Recovering loop costs only from flat end-user dial tone rates, as though the loop remained entirely non-traffic sensitive, would no longer provide the correct economic signals to end-users, competitors, and investors. Exh. AG-1, p. 11.

¹⁶ "For several reasons, the Department finds that it is not feasible or desirable to institute cost-of-service regulation for only one set of Verizon customers." Phase I Order, p. 97. AT&T's witness, Professor Mayo, appears to agree. He testified that "the Department will be best served by establishing a set of efficient prices that break from traditional make-whole residual pricing methods." Tr. 3, p. 292.

Sixth, Verizon has not provided the Department with its statement of earnings or subjected itself to an earnings review that would show that its proposed residential dial tone increase would be “revenue-neutral” to itself or its residential customers, or that failure to compensate Verizon for switched access revenue actually lost would result in confiscatory rates. Before increasing dial tone rates now for future estimated lost toll revenues, the Department should examine Verizon’s earnings and all of Verizon’s toll market revenues, including revenues generated through its reclassification of calls to wireless phones from local calls to toll calls. Tr. 1, pp. 62-68; Exh. AG-4; Exh. AG-VZ-5-1.

2. Charging customers for Touch-Tone service that they have not requested would be unfair .

Part of Verizon’s proposed monthly residential dial tone rate increase (\$.47) results from its proposal to change the optional Touch-Tone service to a mandatory service and include that charge as part of the dial tone charge. Exh. VZ-2, Attachment A, Tab B, Attachment I, Workpaper 1 (revised 8/28/02). According to Verizon, this proposal will affect about 238,879 residential customers who do not currently have Touch-Tone service. Exh. AG-VZ 1-4; Exh. AG-VZ 2-8.

Verizon has provided no evidence why Touch-Tone service must or should be changed from an optional service to a mandatory service. The record shows only that Verizon now wants to charge all its residential customers for the service. “Chapter 159, § 14, mandates a just, reasonable, **and nondiscriminatory rate structure.**” *New England Telephone and Telegraph Company v. Department of Public Utilities*, 372 Mass. 678, 684 (1977) (emphasis added). Verizon’s proposal would be unfair because it favors one class of customers (those who want the

service) over another (those who do not want or need the service) without adequate justification, and forces customers to pay for a service they may not want or need. See *Attorney General v. Department of Public Utilities*, 390 Mass. 208, 235 (1983) ("unless there is a reasonable justification for significant differential in the rates of return of classes, perhaps based upon differences in usage or on public policy considerations ... continuing substantial differences in the rates of return of classes may result in 'unduly or irrationally discriminatory' rates"); *Boston Board of Real Estate v. Department of Public Utilities*, 334 Mass. 477, 495 (1956), (some "reasonable justification" is necessary if rates to customers taking different services are not to be found to be "unduly or irrationally discriminatory."); G.L. c. 159, §§14 and 20.

Verizon has not adequately shown that its residential dial tone rate should increase to reflect Verizon's wish to make Touch-Tone service mandatory, and the monthly dial tone increase would unfairly fall on customers who have not requested Touch-Tone service. Therefore, the Department should reject Verizon's request to increase dial tone for a mandatory Touch-Tone charge.

B. The Department Should Reject Proposals By Verizon And AT&T To Allow Increases To Residential Rates Without Further Review.

1. Verizon's request for authority to raise residential rates up to five percent each year without further review represents a request for a general increase in rates.

Verizon asks the Department to grant the Company (in addition to dial tone increases that could be as high as \$7.00 per month or 70%) the authority to raise all residential rates regulated by the Department by up to five percent per year for an indefinite period without further

Department review.¹⁷ Each such annual rate increase would affect the majority of the Company's customers, as well as the vast majority of customers whose services the Department will continue to regulate.¹⁸ Each such annual rate increase would cause Verizon's aggregate revenues to increase. The Department has found that where the operation of a price cap formula could increase aggregate revenues, it would most likely represent a "general increase" in rates. *New England Telephone and Telegraph Company*, D.P.U. 94-50, p. 219 (1995); G.L. c. 159, §20. Verizon's request in this case for authority to implement a series of such annual rate increases without further review, and without any price cap productivity factor or other offsets, represents a request for a "general increase" in rates subject to G.L. c. 159, §20.

2. Where Verizon has proposed a general increase in rates, the Company has the burden to prove that proposed rate increases are necessary to obtain reasonable compensation for the service rendered and would produce rates that are just and reasonable and non-discriminatory.

By statute, where a common carrier proposes a general increase in rates, the Department must hold a public hearing and make an investigation as to the propriety of proposed rate changes. G.L. c. 159, §20. The Department thereafter may make, regarding any proposed rate

¹⁷ The Company contends that a five percent rate increase is *de minimis* compared to rate increases that have occurred in the cable industry. Exh. VZ-2, p. 12. The statute does not require that a rate increase be of any particular size in order to be a "general increase in rates." G.L. c. 159, § 20. The proposed five percent increases would not be *de minimis*; at five percent, Verizon would collect from residential ratepayers approximately \$31 million additional revenue in the first year, escalating to \$38 million in year five, for a potential total of about \$300 million over five years on the basic service portion of the rates, not including toll or vertical services. The same arguments apply against AT&T's proposal that the Department allow Verizon to raise its basic residential rates by ten percent for each of the next three years without further Department review. Exh. AT&T-1, p. 16. Under Verizon's plan, rates could increase five percent per year indefinitely without Department review.

¹⁸ Verizon has not shown, or even attempted to show, that residential services are "sufficiently competitive" to remove pricing constraints. The Department has granted Verizon market-based pricing flexibility for most of its business services, but not its residential services. DTE 01-31, Phase I Order, pp. 91, 99 (2002).

changes, “such order as would be proper under a proceeding under section fourteen.” *Id.* The Department shall “determine the just and reasonable rates”, where the agency concludes after hearing that rates are “unjust, unreasonable, unjustly discriminatory, unduly preferential, in any wise in violation any provision of law, or insufficient to yield reasonable compensation for the service rendered” G.L. c. 159, § 14. The Department had to investigate Verizon’s proposed general rate increase under Section 20 and could determine under Section 14 whether the proposed rate changes would be just and reasonable, non-discriminatory and necessary for Verizon to obtain a reasonable compensation for the service rendered. While existing rates are presumed to be reasonable until changed, G.L. c. 159, § 17,¹⁹ that presumption does not apply to proposed rate increases. G.L. c. 159, § 20.

The Court has granted the Department substantial leeway regarding the methodology used to determine just and reasonable rates. *Attorney General v. Dep’t of Pub. Utils.*, 392 Mass. 262, 268 (1984); *American Hoechst v. D.P.U.*, 379 Mass. 408, 413 (1980); *Massachusetts Elec. Co. v. D.P.U.*, 376 Mass. 294, 302 (1978).²⁰ The Department, however, may not ignore the

¹⁹ “... charges heretofore established and set out in any schedule filed as provided in sections nineteen and nineteen A shall be deemed prima facie lawful until changed or modified by the department under the powers conferred upon it by this chapter, but this provision shall not give to such rates any greater weight as evidence of the reasonableness of other rates than they would otherwise have.” G.L. c. 159, § 17.

²⁰ The Department stated in 1995 that “the Court has never addressed the precise question of whether the Department can permit substitution of an alternative regulatory scheme, such as price cap regulation, for traditional cost-of-service regulation ...” *New England Telephone & Telegraph Company*, D.P.U. 94-50, Interlocutory Order On Motion To Dismiss of the New England Cable Television Association, Inc., p. 42 (1995). The Department adopted a price cap method in that case, with a freeze for basic residential rates, after conducting a review of the Company’s earnings. *New England Telephone & Telegraph Company*, D.P.U. 94-50, pp. 274, 503 (1995). The Court still has not decided the legality of price cap regulation under Chapter 159. While the Court discussed price cap regulation in a recent case, that was under a new statute for electric and gas companies under G.L. c. 164, not for
(continued...)

constitutional and statutory limits or the numerous court decisions requiring that rates be neither confiscatory nor exorbitant regardless of the ratemaking methods employed during the proceedings. *Washington Public Interest Organization v. Public Service Commission*, 393 A. 2d 71, 76-77 (D.C. Ct. Ap. 1978) (consumer and investor interests must be considered in setting reasonable rates), citing *Washington Gas Light Co. v. Baker*, 188 F. 2d 11, 15 (1950) *cert. denied* 340 U.S. 952 (1951)(the zone of reasonableness for rates “is bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates”); *See Permian Basin Area Rate Cases*, 390 U.S. 747, 769 (1968) (“investor interests provide only one of the variables in the constitutional calculus of reasonableness”). The Department must carefully balance the “investor and consumer interests in permitting a reasonable return on the utility’s investment.” *New England Telephone & Telegraph v. Department of Public Utilities*, 360 Mass. 443, 472 (1971)(“[T]he fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests”); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602-603 (1944)(“Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling”); *Bluefield WW & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 692-93 (1923) (a company has no right “to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.”)

For the Department to approve Verizon’s Plan would be an improper delegation to

²⁰(...continued)
telecommunications companies under G.L. c. 159, and the company in that case did not challenge the Department’s decision to choose performance-based ratemaking over cost of service or rate of return. G.L. c. 164, §1E; *Boston Gas Company v. Department of Telecommunications and Energy*, 436 Mass. 233, 238 (2002).

Verizon of its statutory review authority and an abdication of its obligation to protect the public interest, contrary to G.L. c. 159, §§ 14 and 20. *See, Lowell Gas Light Company v. Dept. Pub. Utilities*, 319 Mass. 46, 52 (1946) (“the function of the Department is the protection of the public interests and not the promotion of private interests”)

3. The other parties have not shown that such rate increases would be just and reasonable, non-discriminatory and necessary to obtain reasonable compensation as required by statute.

Verizon seeks authority to raise residential rates up to five percent each year without further Department review. Exh. VZ-2, p.7. Verizon’s proposed alternative regulatory scheme does not contemplate any review of the company’s current earnings, either in this case or regarding proposed future increases each year of up to five percent. The Department has in the record, and will have under Verizon’s proposal, no evidence showing that these proposed rate increases would be just and reasonable and non-discriminatory. Verizon also has not carried its burden to show that proposed rate increases are “necessary to obtain reasonable compensation for the service rendered” G.L. c. 159, § 20. AT&T proposes that the Department allow Verizon to increase residential rates up to ten percent for each of the next three years without further review. Exh. AT&T-1, p. 16. Neither party has presented evidence showing that residential rates are below current costs. Exh. AG-2, pp. 4-6; G.L. c. 159, §§14 and 20. Instead, Verizon and AT&T rely on elasticity studies, some as old as the 1970’s and none based on data more recent than 1990, to argue that the Department should allow Verizon to recover its revenue requirement by raising rates for what they think is the most inelastic rate element, the residential dial tone. Exh. AG-1, p. 13; Exh. AG-2, pp. 7-9.

The Department has indicated its desire to establish efficient and Ramsey efficient prices.

Phase I Order, p. 99. Setting efficient prices for a regulated utility recovering a revenue requirement, however, is more complicated than simply ordering rates anywhere between stale estimates of incremental and stand-alone costs; it requires knowledge of **current** incremental costs, embedded cost of serving classes, and Verizon's revenue requirement or at least earnings to avoid confiscatory or monopoly level pricing. DTE-ATT 4-1; Exh. AG-2, pp. 5-8; Tr. 2, pp. 183-184. The record contains none of these three data sources. Exh. AG-2, pp. 5-6; Tr. 2, pp. 218, 250-251.

Current incremental costs are needed to set efficient prices because, in general, rates should not be set below incremental costs. Tr. 2, p. 179. Verizon's most recent estimate of marginal cost, which dates back to 1993, shows that residential rates are not subsidized; rather, they exceed marginal costs. Tr. 2, p.181.

The Department conducted its last full rate case, reviewing the Company's revenue requirement, affiliate transactions, cost allocation and rate structure, in the mid to late 1980's, based on data that are now more than 15 years old. *New England Telephone and Telegraph Company*, D.P.U. 86-33-G (1989). In 1994, when the Department was considering a move to price cap regulation for NYNEX, Company rate data were seven to eight years old. The Department recognized that a review of current earnings was needed, and also looked at incremental cost data from 1993. *New England Telephone and Telegraph Company*, D.P.U. 94-50, p. 274 (1995).²¹ The price cap that the Department implemented in D.P.U. 94-50 expired

²¹ Similarly, the Department conducted full reviews of revenue requirements and class-specific rate design before beginning price caps for two gas companies. *Boston Gas Company*, D.P. U. 96-50, (Phase I)(1996); *Berkshire Gas Company*, D.T.E. 01-56 (2002). The Department suspended the effective date of proposed rates and investigated for six months in all three of these price cap cases. *New England* (continued...)

August 15, 2001, and the Department now is again considering a new mechanism for setting rates. As in D.P.U. 94-50, it has again been approximately eight years since the last earnings review was conducted.²² Despite the passage of nearly a decade and the significant intervening changes in the industry, including merger savings, economies of scope and scale, Verizon has not provided any revenue requirement or earnings data or cost of service studies to support its proposed rate increases. Tr. 2, p.250.

The Department should not simply design rates by applying the inverse Ramsey pricing rule and assigning all joint and common costs to the least elastic rate element, as it suggested in its “tentative conclusions.” Phase I Order, p. 101. Implementing Ramsey-efficient prices is far more complicated than such a ratemaking approach implies, requiring knowledge of cross elasticities and what would happen to complementary services if the Department were to raise dial tone rates.²³ Tr. 2, pp. 219, 251. Ms. Brown, Dr. Taylor and Professor Mayo speculate based on their experience that residential dial tone service is still relatively inelastic (Tr. 1, pp. 34, 77; VZ Exh. 5, pp. 18-20; Exh. ATT-2, p. 11; Exh. VZ-6, p. 21), but they present no studies

²¹(...continued)

Telephone and Telegraph Company, D.P.U. 94-50, Suspension Order, April 20, 1994; *Boston Gas Company*, D.P. U. 96-50, Suspension Order, May 23, 1996; *Berkshire Gas Company*, D.T.E. 01-56, Suspension Order, July 17, 2001.

²² The Department also has determined that wholesale rates should be reviewed at least every five years due to changes in the industry and, indeed, is finishing up its quincennial wholesale rate review in Verizon’s Unbundled Network Elements, D.T.E. 01-20 (“UNE Docket”). Because the same infrastructure supports the wholesale and retail networks, there is no reason that retail rates should require less frequent review in light of the same changes in the industry. Exh. AG-1, p.5.

²³ According to Dr. Taylor, the “Department has consistently rejected estimates of elasticity of demand as inherently speculative in nature and not subject to reasonable estimation, a position upheld by the Supreme Judicial Court. See D.P.U. 85-266-A/85-271-A at page 56 footnote 8.” Phase I, Exh. DTE-VZ 1-10, page 1, quoted in Phase II, Exh. AG-VZ 3-20.

upon which the Department could reasonably rely as a basis for adopting an alternative rate scheme and major increases to basic residential rates, as Verizon and AT&T propose.

The Department cannot determine Ramsey-efficient rates from the information in this record because Verizon has made no studies of Massachusetts own- or cross-price elasticities.²⁴ Exh. AG-2, pp. 7-8. Verizon provided industry data on elasticities, but most of that data was from the 1970's, pre-divestiture, with one study that extended to 1983. Exh. AG-2, pp. 8-9. AT&T supplied post-divestiture elasticities estimates, but they were still fifteen years old. Exh. DTE-ATT 4-1; Tr. 2, pp. 202-203. AT&T also supplied articles discussing other elasticity articles published in 1990. Tr. 2, pp. 208-209. Data change over time, however, and such stale data are no longer relevant.²⁵ Exh. AG-2, p. 8-9; Tr. 2, p. 221. The more recent elasticity data in the record are equally flawed. If Verizon applied the results of the one more recent elasticity study (of intraLATA toll in Maryland), that would triple the amount of additional revenue expected from demand stimulation caused by switched access rate reductions. Assuming, therefore, Verizon's contention that there needs to be revenue-neutral adjustments when access rates change, the price of residential service should be reduced. Exh. AG-2, p. 10; Tr. 2, p. 202.

The most recent elasticity of demand data that Verizon relies upon were collected in

²⁴ Verizon was not able to supply Massachusetts-specific data for industry-wide own-price elasticities or selected firm-level own price elasticity coefficient estimates. Exh. AG-VZ 1-1; Exh. AG-VZ 1-6. Verizon could not provide any estimates of the own-price elasticity of demand for its regulated residential basic services. Exh. DTE-VZ 4-1.

²⁵ If the Department does consider the stale elasticity data, those data do not support a conclusion that intraLATA toll is much more elastic than access. The long run elasticity presented by Verizon for access (.27) is only slightly lower than Verizon's estimate of the elasticity for intraLATA toll (.3). Tr. 2, p. 220. Since the old data were collected, the Department has implemented a major rate rebalancing in D.P.U. 89-300 and succeeding cases, raising residential dial tone rates and local calling rates substantially and reducing intraLATA toll substantially. These rate changes would tend to lower toll elasticities and raise access elasticities. Tr. 2, pp. 220-221.

1993. The industry and Verizon's markets have changed fundamentally since 1993, with, among other changes, the development of alternatives to Verizon's wireline products (including wireless, competitive suppliers, and cable), rebalanced prices, new technologies, and new price bundles. Exh. AG-1, pp.13-14; Exh. AG-2, p.5. Dr. Taylor testified for Verizon that "[i]mplementation of the Telecommunications Act of 1996, along with changes in regulation and technology, has changed the fundamental structure of telecommunications markets in Massachusetts and throughout the United States." Exh. VZ-3, p.4. The local loop also has become more traffic sensitive with changes in technology. Tr. 2, p. 223; Exh. AG-1, p. 11. The record does not contain elasticities that are anywhere near current, and therefore the proposed price increases cannot be characterized as Ramsey-efficient. Exh. AG-1, p. 14. Other evidence indicates that dial tone and local usage are not completely inelastic in the two dollar range of price increases proposed by Verizon. Exh. AG-1, pp. 20-21.

The Department should not rely on stale data,²⁶ whether it is elasticity studies from the 1970's, full rate case data from the 1980's, or incremental costs, earnings data, and elasticity estimates from 1993, to presume in 2002 that increased rates would be just and reasonable and necessary to obtain reasonable compensation. Tr. 2, p. 251. This is especially true in an industry where overall costs have been declining, as the United States Court of Appeals for the District of Columbia found recently in a Verizon case. *WorldCom, Inc. et al., v. F.C.C.*, No. 01-1198, __

²⁶ *Attorney General v. Comm'r of Insurance*, 370 Mass. 791, 799 (1976) ("We may note that if an average over a longer period would produce a result less subject to fluctuation, it might do so at the expense of using data that could be regarded as obsolescent or stale."); *Berkshire Gas Company*, D.T.E 01-56, p. 32 (2002) (year old data too stale for unbilled revenue adjustment); *Investigation by the Department of Telecommunications and Energy on its own Motion to Establish Guidelines for Service Quality Standards for Electric Distribution Companies and Local Gas Distribution Companies Pursuant to G.L. c. 164, § 1E*, D.T.E. 99-84 (2000) (requirement that benchmarks not be based on stale data).

F.2d __ (D.C. Cir. 2002), p. 7 (Slip opinion); Exh. AG-2, p. 14.²⁷

4. Verizon has not shown that inflation justifies five percent increases each year.

Verizon suggests that five percent increases are reasonable given general inflation over the past 73 years. Exh. AG-VZ-3-14. The record contains no evidence that tracking general inflation would yield just and reasonable residential rates. Even if tracking inflation were a reasonable method for setting Verizon's residential rates, five percent far exceeds reasonable estimates of inflation. The Consumer Price Index ("CPI") has exceeded five percent only twice in the past twenty years, in 1982 and 1990. Exh. AG-2, pp. 24-25. From 1994 to the present, the CPI fluctuated between 1.6 percent and 3.4 percent. Exh. AG-VZ 2-6. The CPI is expected to fluctuate between 1.4 and 2.8 percent between 2002 and 2007, and average 2.5 percent over the next ten years. Exh. AG-2, pp. 24-25. Price increases exceeding actual inflation would be inefficient, reflecting neither true costs nor industry trends. *Id.* Verizon's proposal is similar to continuing the price cap without the basic residential rate freeze, approximately doubling the inflation factor, and dropping the productivity offset that led to residential refunds of \$16.3 million in 1996. D.P.U. 96-68, Compliance filing, June 10, 1996. Verizon has not shown that any of these changes are "necessary to obtain a reasonable compensation for the service rendered." G.L. c. 159, §20.

Finally, Verizon has not set a time frame for its Phase II Plan. Exh. AG-VZ 5-9. This means the approved regulatory plan would continue indefinitely. Verizon has entered no

²⁷ The declining cost nature of telecommunications is also reflected in the fact that, under the Department-approved Price Cap Plan, Verizon's customers as a whole received \$296 million in rate reductions and bill credits. D.T.E. 01-31 (Phase I) Vote and Order to Open Investigation, p. 2 (February 27, 2001).

evidence as to how these increases would impact the return to investors. The Department should not assume, without evidence, that, if it allows Verizon to raise residential rates up to five percent per year indefinitely, rates would continue to be just and reasonable, non-discriminatory, and necessary to obtain a reasonable compensation for the service rendered, regardless of how many times Verizon raises them.

5. Based on the record data, Verizon's current residential retail rates are not below costs or subsidized.

Although AT&T and Verizon argued that current residential rates are too low though not subsidized in the traditional sense (*i.e.*, that the rates are below their cost of service, though not below marginal costs), they provide no cost data to support their positions. Tr. 3, pp. 266, 270; Exh. ATT-1, p. 9; Exh. VZ-6, p. 5, Exh. AG-2, p. 19. The Attorney General presented publicly-available data from the Federal Communications Commission ("F.C.C.") showing that residential service rates are not below their current costs. Exh. AG-1, pp. 6-7, 14-15.²⁸ The local service rate, including Touch-Tone and Subscriber Line Charge ("SLC"), but without the increases proposed in this case, is schedule to increase to approximately \$25.63 in July 2003. *Id.* The current cost of serving residential customers, based on unbundled network elements plus customer service and marketing costs, is between \$22.01 and \$23.34, depending on differences in

²⁸ The Department asked questions in the hearings about whether the sum of the total element long run incremental costs ("TELRICs") of the unbundled network elements ("UNEs") that provide dial tone service (loop, switch, port and transport) approximates the long run total service incremental cost ("TSLRIC") for dial tone service. Tr. 2, pp. 229-242. The Department should not assume that TELRIC approximates TSLRIC. The TELRIC price is generally much higher than the TSLRIC price because, among other reasons, TELRIC includes common and joint costs that are excluded from TSLRIC. Exh. AG-1, pp. 11-12; Tr. 2, pp. 185-186, 230.

the estimation of switching costs. Exh. AG-1, pp. 8, 14-15.²⁹ Verizon, therefore, is either breaking even or earning a surplus from residential customer basic rates, and its proposed increases would be inefficient since the price already exceeds 100% of the shared cost of the loop. Exh. AG-1, p. 9. Residential rates also exceed Verizon's latest estimate, based on 1993 data, of marginal costs. Tr. 2, p. 181.

The Department should not step back from rate regulation at this time and assume that the market is sufficiently competitive to discipline Verizon's pricing of residential services. Residential markets are not effectively competitive and are losing entrants in what Dr. Gabel described as a recent "meltdown" in telecommunications. Exh. AG-2, p. 17. Market entry requires very high sunk investments, even for resellers. Those investments, which include customer acquisition costs approaching \$400 per customer, operational support systems, and employee training costs, are a barrier to entry. Exh. AG-2, pp. 17-18. Firms decide whether to enter a market based on the overall expected profitability, not on individual prices. Entry is impeded, therefore, despite the profitability of basic exchange service. The lack of entry is not due to the current rates being inefficient, but to the fact that the margin on basic exchange service is not sufficiently high for competitors to recover their customer acquisition and other costs. Exh. AG-2, p. 23. Absent regulatory intervention, oligopolist behavior and higher prices are likely to be the norm. Exh. AG-2, p. 17.

Section 254(k) of the Telecommunications Act of 1996 explicitly states that:

The States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services

²⁹ AT&T challenged Dr. Gabel's retail service cost number, preferring to estimate the cost using the avoided cost discount. Exh. AT&T-2, p. 6; Tr. 3, pp. 289-290.

included in the definition of universal service bear **no more than a reasonable share** of the joint and common costs of facilities used to provide those services.

Exh. AG-1, pp. 31-32 (emphasis added). Since dial tone and local calling are included within universal service, the Department may not assign **all** joint and common costs to those services and none to services outside of universal service such as toll, DSL and vertical services. Section 254(k) of the Telecommunications Act prohibits states from allowing non-competitive services to subsidize competitive services.

Another reason that residential rates are not below cost or subsidized relates to changes in technology. The loop may now carry multiple products and services, not just voice calls, and affords the owner of the loop multiple revenue streams. Exh. AG-1, p.28. The F.C.C. has treated loop costs as common inputs with shared cost allocations, as shown in its recent Verizon Vermont and Verizon New Jersey Section 271 applications. Exh. AG-1, p. 10, n. 20. Verizon itself argued that it is a violation of F.C.C. rules to recover none of the loop costs from data services. *USTA v. F.C.C.*, Case No. 00-1012, p. 22 (May 24, 2002).³⁰ Because the loop is a shared or joint input for data and voice, the incremental cost of voice service should be zero. In calculating the retail rate, the Department should divide loop costs among all services that

³⁰ Verizon's own witness, Dr. Taylor, indicated in another state proceeding that the cost of the loop "is a shared fixed cost" between voice access to the network and high frequency data. Exh. VZ-7, p. 19-20. Dr. Taylor explained that;

[t]hough cost consideration can tell you what the portion of the cost of the loop economically belongs to voice service as opposed to high frequency data service. The individual incremental costs of the voice access are not defined in economics, but economics can tell you how, for example, in a competitive market those costs would be recovered, the cost of the loop would be recovered from voice services in part and from data services in part.

Exh. VZ-7, pp. 20-21; Tr. 2, pp. 254-255. Dr. Taylor also added: "[t]he first thing that you should remember and keep firm in your mind is that when you have truly joint products, you can't say anything about the individual incremental costs of the services." Exh. VZ-7, p. 90.

depend on the loop, including local, interstate toll, high frequency data and vertical services.

Exh. AG-1, p. 10, 28-29.

Verizon has the burden to show that increases falling entirely on the residential class would not be discriminatory. G.L. c. 159, §§14 and 20. The Department indicated in its “tentative conclusions” that any price between a floor of incremental cost and a ceiling of stand-alone costs “must perforce be just and reasonable.”³¹ Phase I Order, p. 102. It is not reasonable to conclude, based on stale 1980's and early 1990's data, that it would be just and reasonable and non-discriminatory to raise rates as Verizon proposes. Only after investigating current revenue requirement (or at least earnings) and recent cost of service studies may the Department conclude that raising residential rates above current levels would not exceed the statutory ceiling and would yield just and reasonable and non-discriminatory rates that are necessary for Verizon to obtain reasonable compensation. G.L. c. §§14 and 20.

6. Raising retail residential rates may reduce universal service in Massachusetts.

Under Federal law, the Department must “ensure that universal service is available at rates that are just, reasonable, and affordable.” 47 U.S.C. § 254(i). If the Department approved all rate changes proposed for immediate implementation in this case, however, basic residential dial tone would rise between approximately \$2 and \$7 a month. Tr. 2, pp. 108-112. Although increasing rates to encourage competition in the residential local market could lead, theoretically and ultimately, to lower prices and other benefits, artificially creating competition by having high

³¹ The Department also stated in its “tentative conclusions” that “historical evidence has shown that residential rates are likely below their efficient levels,” citing D.P.U. 89-300 (1990). Phase I Order, pp. 96 and 100.

prices does not bring any of these benefits and, indeed, can be extremely costly and inefficient. Exh. AG-1, p. 22; Tr. 2, pp. 241-242. One such cost may be a decreased penetration rate of phone service in the Commonwealth. Every incremental price increase may deprive additional consumers of the ability to have basic residential telephone services.

According to a recent report by the Federal Communications Commission, Massachusetts has the lowest penetration rate for phone service in all of New England. Only 95.6 percent of all Massachusetts households have basic telephone service as of November 2001.³² Moreover, this penetration rate has actually dropped .2 percent since 1984. *Id.* Massachusetts is one of only five states in the United States that experienced a decline in subscriber penetration between 1984 and 2001. *Id.* The 1990's experience may be instructive.³³ The Department raised basic residential rates from 1990-1994. Massachusetts' penetration rate fell 3.4 percent from 1993 to 2000, a period that encompassed consumers' longer term reaction to the rate increases. Exh. AG-2, pp. 11-12. From 1997-2001, Massachusetts' penetration was unchanged, while the national average increased by .5 percent. *Id.* During those years, the penetration for Massachusetts low income households dropped .3 percent, while nationwide penetration increased 1.6 percent. Exh. AG-2, pp. 14-15. These distinctions between Massachusetts and her sister states should cause the Department heightened concern when it is considering raising basic

³² Other New England states' penetration rates for 2001 are as follows: New Hampshire 98.3 percent; Maine 97.8 percent; Vermont 97.2 percent; Rhode Island 96.3 percent; and Connecticut 96.1 percent. "Telephone Subscribership in the United States (Data through November 2001)," Industry and Technology Analysis Division, Wireline Competition Bureau, Federal Communications Commission, released May 2002, Table 2, p. 8; Exh. AG-2.

³³ Determining the causes of subscription decline would require careful analysis. Exh. AG-2, p. 15. The Department should open a proceeding to investigate the causes of reductions in universal service.

residential rates again.

Approximately 208,689 households in the Commonwealth do not have basic telephone service, based on the F.C.C. report and a recent census report.³⁴ Although Verizon proposes to increase the LifeLine credit for its 163,605 low-income customers, there are even more households that do not have basic phone service. Exh. VZ-2, Attachment A, Tab B, Attachment I, Workpaper 1 (revised 8/28/02); Exh. AG-VZ 1-4. The potential harm to universal service that would likely result from proposed increases to basic residential service rates is one more reason that the Department should reject those proposed increases.

C. The Department Should Reject Verizon's Proposed Rate Increases And Instead Freeze Residential Rates Until It Has Reviewed An Independent Audit of Verizon's Regulatory Accounting, Verizon's Current Earnings Data, And Current Costs To Serve Residential Customers.

According to Verizon, its regulated residential retail rates, which have not changed since the Price Cap Plan ended on August 15, 2001, are just and reasonable. Exh. AG-VZ 5-11; RR AG-1; Tr. 2, pp.117-119; Exh. VZ-2, page 14; Exh. AG-VZ 3-18. While **existing** rates are presumed to be just and reasonable under G.L. c. 159, § 17, Verizon is proposing rate changes; the presumption of reasonableness does not apply to the proposed rate increases. Verizon's rates also should not be presumed to be just and reasonable where they were based on revenue requirement data that are now sixteen years old and earnings and marginal cost data that are now nine years old. *New England Telephone and Telegraph Company*, D.P.U. 86-33-G (1989); *New England Telephone and Telegraph Company*, D.P.U. 94-50 (1995).

³⁴“Telephone Subscribership in the United States (Data through November 2001),” *supra*. According to the U.S. Census Bureau, “Quick Facts,” Massachusetts 2001 population estimate based on 2000 data, Massachusetts population is 6,379,304.

Before authorizing Verizon to implement any residential rate increases, the Department should order the Company to file, and should investigate over an adequate period (at least six months): 1) a full current cost of service/revenue requirement, or, at a minimum, complete current earnings data; 2) the results of an independent audit of Verizon Massachusetts's regulatory accounting; and 3) a current fully allocated Cost of Service Study/"Stand-Alone" Study so that the Department can properly determine whether any increase to basic residential rates would be just and reasonable, non-discriminatory and necessary to obtain reasonable compensation. See G.L. c. 159, §14.

Until it completes those reviews, the Department should freeze all regulated residential retail rates listed in Exh. VZ-1, Tab A, Attachment A, June 5, 2002 Compliance Filing. The Department has ordered a rate freeze in several previous cases. *See, e.g., New England Telephone and Telegraph Company*, D.P.U. 94-50, p.228 (1995); *Boston Edison Company*, *Cambridge Electric Light Company*, *Commonwealth Electric Company* and *Commonwealth Gas Company*, D.T.E. 99-19 (1999).

D. The Department Should Deny Verizon's Request To Eliminate Its Outdated Service Quality Plan And Order The Company To Propose A New Plan To Improve Service Quality.

The Department should reject Verizon's proposal to eliminate a service quality plan, reject Verizon's current service quality plan as outdated, and open an investigation into setting rising service quality standards and thresholds for Verizon's retail service.

1. The purpose of a service quality plan is to maintain a minimum level of service and persuade the Company not to degrade service.

Verizon is the dominant provider of residential telephone service in a market that is not

sufficiently competitive to remove pricing constraints.³⁵ As a result, market forces alone are insufficient to prevent Verizon from allowing its service to degrade while increasing Company profits. The Department has recognized this lack of competition and should not release the Company from the restrictions of a service quality plan, as the Company seeks. Exh. AG-VZ 2-5. Instead, the Department should require Verizon to maintain an effective service quality plan.

Service quality plans should contain financial penalties for failing to achieve a specified service level. *New England Telephone and Telegraph Company*, D.P.U. 94-50, p. 235. Without effective financial penalties, a company could increase its profits by reducing service quality for captive customers. *Id.*, pp. 235-236. The financial penalties should reflect individual service items as well as overall measurement of service quality. *Id.*, p. 238. The service quality plan created under D.P.U. 94-50 was tied to a price cap productivity factor. If the Department does not continue the productivity factor, it should order Verizon to make one-time payments to retail customers for any substandard retail service. Exh. DTE-VZ 3-7.³⁶

The Department has found that service indicators should be submitted on a regular basis.

³⁵ Based on publicly available data from the F.C.C., at least 93% of all Massachusetts end users depend on Verizon to maintain a high level of service quality. Exh. DTE-AG 1-1. As mentioned earlier, Verizon did not seek pricing flexibility for residential services. Phase I Order, p. 97.

³⁶ Verizon's annual Price Cap compliance filings showed the applicable service quality penalty based on annual revenues, Gross Domestic Product Price Index, Consumer Price Index, and exogenous costs. Residential and business customers received \$21 million in rate reductions and refunds due to deficient service quality penalties which arose during the first and second Price Cap compliance filings. D.P.U. 94-50, First Price Cap Compliance Filing, July 3, 1995, Second Price Cap Compliance Filing, D.P.U. 96-68, June 10, 1996. Verizon sought to recover those penalties in the Fifth Price Cap Compliance Filing (*Bell Atlantic*, D.T.E. 99-102), but the Department rejected those attempts and required Verizon to return \$20.87 million plus interest to ratepayers. D.T.E. 99-102, Order (August 3, 2000).

New England Telephone and Telegraph Company, D.P.U. 89-300, p. 301 (1990).³⁷ The Department also has found that periodic review and analysis of the data are necessary to detect unreasonable, unsafe, or inadequate service quality. *Id.*, p. 306. The Department should require Verizon to use service indicators based on updated data.

2. Verizon's current service quality plan is outdated.

Verizon's current service quality plan measures twelve service items categorized in three standard business units, and five response items. Exh. DTE-VZ 1-3; Exh. AG-VZ 2-5; Exh. VZ-4, Attachment 2, Section 2. Those items consist of: (1) network trouble report rate; (2) percent of trouble cleared within 24 hours - residence; (3) percent of trouble cleared within 24 hours - business; (4) percent of missed installation appointments for company reasons - total; (5) percent of missed installation appointments for company reasons - residence; (6) percent of missed installation appointments for company facilities; (7) percent installation troubles; (8) directory assistance average speed of answer; (9) toll and assist average speed of answer; (10) repair resolution center average speed of answer; (11) residence service level; and (12) business service level. *Id.* Verizon files monthly Quality of Service Reports with the Department and the Attorney General. Exh. AG-VZ 2-5.

The last time the Department crafted service quality categories for Verizon, it primarily used data from 1986. *New England Telephone and Telegraph Company*, D.P.U. 89-300 (1990). The last time the Department set thresholds (service standards) for service quality was in 1995, using data from 1992 and 1993. *New England Telephone and Telegraph Company*, D.P.U. 94-

³⁷ The Department has reviewed both internal and external company data in evaluating quality of service. *Id.*, pp. 292-299.

50; Exh. DTE-VZ 1-5. Even though much has changed since 1986 and 1993 in the telecommunications field, Verizon has not changed its service quality categories or service thresholds to reflect the changing markets or Verizon's ability to provide increasingly higher quality service. Exh. DTE-VZ 1-6.

3. The Department should strengthen service quality performance standards and thresholds.

The Department has found that it must periodically review and analyze the Company's service quality data to detect unreasonable, unsafe, or inadequate service quality. *New England Telephone and Telegraph Company*, D.P.U. 89-300 (1990), p. 306. Now is the time for the Department to update Verizon's service quality categories and thresholds. The service standard thresholds are nearly ten years old, and the service quality categories are over twelve years old.

The Department should order Verizon to report and analyze its ten years' most recent consumer complaint data and should investigate adjusting the thresholds each year to match the rolling data to ensure that the current service quality items and thresholds adequately address the current consumer complaints. Verizon routinely collects and analyzes internal and external data on consumer complaints, much as it did in preparation for D.P.U. 89-300. Tr. 2, pp. 143-145, 155; DPU 89-300, pp. 292-299.³⁸ The Company reports that it has met existing service quality standards for at least 83 months, but the Department has not required Verizon to improve its service quality standards. Exh. AG-VZ 2-5. The Department should consider for use in Massachusetts the wealth of data provided in the Company's response to Exh. DTE-VZ 1-8 on

³⁸ In D.P.U. 89-300, the Department reviewed complaint data from internal and external sources, including monthly service quality reports, external phone surveys, customer appeals, complaint referrals from the DTE and other agencies. Tr. 2, pp. 154-156.

different types of service quality items and thresholds used in other jurisdictions.³⁹

The Department would have to revise Verizon's current service quality standards and thresholds to remove business services from the Company's service quality plan, as the Department previously suggested. Exh. DTE-VZ 3-6. Only three of the twelve service quality items would remain unchanged if the Department requires Verizon to remove business services from the service quality plan. *See also* Tr. 2, pp. 136-138. The Company testified that it cannot modify those three service quality items – directory assistance average speed of answer; toll and assist average speed of answer; and repair resolution center/ repair service average speed of answer – to exclude business service calls because of the way calls come into the call centers and the way the data are accumulated. Tr. 2, p. 137. The Department would have to devise a penalty calculation method for those three service quality items. Tr. 2, pp. 140-141.

The information on the record at this time is insufficient to justify retaining Verizon's outdated service quality plan. The Department, therefore, should require Verizon to report its last ten years of service quality data and should investigate using rolling service quality standards and thresholds.

V. CONCLUSION

For these reasons, the Department should: 1) reject proposed dial tone increases; 2) deny Verizon's request for authority to raise rates without further Departmental review; 3) freeze residential rates; 4) order Verizon to undergo an independent audit of its regulatory accounting; 5) order Verizon to file all data needed to establish the Company's revenue requirement, or at

³⁹ Many states within Verizon's service territories have some form of a service quality plan and require periodic filing of service quality reports. Exh. DTE-VZ 1-8, Exh. DTE-VZ 1-8A (proprietary).

least to show that its current earnings are not excessive; 6) order Verizon to file cost of services studies to establish the current costs to serve residential customers; and 7) reject Verizon's current service quality plan and investigate setting rising standards and thresholds.

Respectfully submitted,
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Dated: November 18, 2002

**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

Investigation by the Department of Telecommunications and Energy) on its own Motion into the Appropriate Regulatory Plan to succeed) Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon) Massachusetts' intrastate retail telecommunications services in the) Commonwealth of Massachusetts)	D.T.E. 01-31 Phase II Track B
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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding by e-mail and either hand-delivery or U.S. mail.

Dated at Boston this 18th day of November 2002.

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